# IMPACT OF INFLATION
# ON THE
# DIRECTORATE OF ADMINISTRATION

At the verbal direction of the Deputy Director for Administration, the Inflation Study Group was established in the spring of 1975 to study the impact which high rates of inflation have had on the activities of the Directorate to date and to recommend methods for dealing with a continued inflationary trend. The following individuals participated in the composition of this report on the impact of inflation on the DD/A:

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25X1A [redacted] ce of Finance
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> Inflation is an all pervasive item which cannot be fought on only one front nor can it involve the efforts of only one Directorate. What is needed now is a re-examination of our management practices to encourage, by direction and example, changes in day-to-day activities which will lead to operating savings.

With those words, the Director of Central Intelligence confirmed his position in late 1974 that the Agency must actively fight inflation. During the past year, the Offices of the DD/A have vigorously pursued programs designed to reduce operating costs while, at the same time, continuing to provide expected and acceptable levels of operations to support Agency requirements. This dual and frequently conflicting task has been difficult to accomplish in the face of double-digit inflation that has recently plagued the economy.

The DD/A, recognizing the erosion of the purchasing power of Directorate dollars, directed that an Inflation Study Group be established to examine the impact which inflation has had on the Directorate as an entity and its Offices in particular. This report of the Inflation Study Group illustrates vividly the shrinkage of the dollar in the recent past and describes some actions that have been taken in DD/A Offices to combat inflation. The report presents some recommendations for dealing with the inflation we can expect in the normal course of events.

Background - The DD/A Dollar Shrinks

Until two years ago, inflation in the economy had been moderate. Federal salaries had risen gradually at a pace exceeding the price increases for goods and services.

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Then this situation suddenly reversed, with the costs of most goods and services bounding ahead. Naturally, this sudden reverse has had the heaviest impact on those Offices which must procure material goods to meet Agency requirements, i.e., the Offices of Communications and Logistics. The more personnel-oriented Offices in the Directorate, while suffering differently from the effects of inflation, have not experienced the almost-instantaneous bursts in the prices of some categories of goods and services.

In order to understand fully the impact of inflation on our dollars, it is necessary to agree upon a common definition of inflation. For the purpose of this study, pure inflation is defined as the increase in the price level of personal services or goods and services to the extent that the price level is not related to significant changes in personnel qualifications or product quality. Inflation is measured in indexes that indicate, usually on a weighted basis, how much prices for selected items have increased relative to a base year. The price index itself measures how much prices have increased; the reciprocal of the index (a deflator) measures how much the purchasing power of the dollar has shrunk. This deflator is used to remove the inflation factor from current dollars, thereby yielding constant dollars or the real value of the dollars in the base year.

Use of constant dollars gives a valid measure of real change in our purchasing power because the price variable has been removed. The deflators we have chosen for use in our study (differentiated between personal services and goods and services) were developed by the Office of Economic Research at the request of the Office of the Comptroller. FY 1967 is used as the base year in the deflator schedule; within the timeframe of FY 1967 to the present, the following graphs illustrate the purchasing power of DD/A dollars and the inflationary trend. It is clear that purchasing power for goods and services remained relatively stable throughout the late 1960's and early 1970's. Although

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the value of our dollars declined somewhat more in FY 1973, it is just in FY 1974-75 that our purchasing power dived steeply. It is a major accomplishment, though, that, over the FY 1967-75 period, the Directorate has continued to function so effectively and maintain its high standards of services in the face of the 10 percent reduction of constant dollars available to it.

THE SHRINKING DOLLAR

Deflators for Use of DD/A Inflation Study Group

| Fiscal Year | Personal Services | Goods and Services |
|---|---|---|
| 1967 | 1.000 | 1.000 |
| 1968 | .967 | .974 |
| 1969 | .912 | .939 |
| 1970 | .804 | .900 |
| 1971 | .757 | .874 |
| 1972 | .705 | .817 |
| 1973 | .659 | .735 |
| 1974 | .617 | .597 |
| 1975 | .585 | .505 |

NOTE: The source of the deflators is the revised Agency purchasing power index prepared by OER for the Office of the Comptroller, 24 January 1975. For personal services, the index has been linked to the 1967-70 index of Federal pay prepared by the Bureau of Labor Statistics. For goods and services, the index has been linked to the 1967-70 index for Defense goods and services prepared by the Comptroller, Department of Defense, July 1972.

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The current dollars of the DD/A Congressional budgets shown in the graphs are historically accurate in that they reflect the functional composition of the Directorate as it existed during those particular years. Because it is not the purpose of this study to plot the organizational changes which have taken place in the Directorate over the past nine years, we have not adjusted budget figures in the graphics to provide for major functional changes. Frankly, it was the majority opinion of the Group that to provide such functional comparability among fiscal years was irrelevant to the study of inflation. Providing that comparability would merely distract from the substance of our report and, as a side effect, would also distort history. The significance of the above graphics is seen in the actual gap between current and constant dollars; we chose not to confuse the message of that gap through a myriad of changes in actual Congressional budget figures.

Personal Services

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Additional personnel cuts could be accomplished without harm to programs only if the cuts are linked to productivity planning. From a management viewpoint, however, it is necessary to assure that productivity-oriented management is not penalized for its very success. In accomplishing drastic staff personnel reductions, some of which have already gone beyond savings from increased productivity, current programs and services have suffered, and DD/A Offices express concern that further deep personnel cuts will more seriously hinder fulfillment of their responsibilities.

Communications message-handling productivity has increased by approximately 50 percent since FY 1967, primarily because of automation and technological advances. As
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a result, [redacted] formerly devoted solely to the operation of the communications network have been deleted. (These reductions do not include personnel assigned to functions transferred outside the Office of Communications.) [redacted] contributed both ceiling positions and other cost savings. Despite this record of productivity increases in the communications sphere, the recent, rapid escalation of inflation for goods and services has created serious problems for cost-conscious management; price increases for materials are now outstripping prospects for cost savings through personnel cuts and productivity improvements.
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In the Agency's financial activities, advances are being made in personnel reductions and productivity. These efforts have been impeded by new and often unanticipated requirements (such as the retroactive pay adjustments and FLSA procedures). In the Office of Finance, a 23 percent decrease in personnel ceiling has been effected since FY 1967. These manpower limitations are having an adverse impact on Agency financial activities as a whole, such as delay in implementation of work-saving computer systems, backlogging of claims and vendor invoices, and reduction of financial support in the field.

The Office of Logistics, which employs many non-GS personnel, exhibits the most obvious increases in salary costs during this inflationary period. While the average salary of GS personnel has been held to increases of approximately five percent per year for several years, the average-salary levels of non-GS personnel (Government printing scale, lithographic wage board scale, etc.) in the Office of Logistics have increased from 19 to 29 percent within the past two years. These increases, patterned after union-negotiated settlements, reflect commercial wage scales.

Some requests for new medical services, [redacted] cannot be satisfied within the present limitations on personal services costs within the Office of Medical Services. Of greatest concern here is the ceiling on supergrade pay which hampers physician recruitment. 25X1A

The major offset to higher pay costs in the Office of Personnel has been a 20 percent reduction in ceiling since FY 1967. Approximately 90 percent of this Office's budget is comprised of personal services costs. The invitee-travel and overseas-medical programs administered by this Office have been adversely affected by cost increases.

Until recently, productivity increases in training operations have provided major offsets to the higher costs of internal training. The Office of Training has reduced staff and contract ceiling positions by 29 percent since June 1968, while the number of student days has increased dramatically. However, as the Office of Training itself has contracted, Agency expenditures for external training have trebled since FY 1967, and the costs per student for such training have increased by two-thirds during the past two years.

With all budgetary and cost pressures intensifying during the past two years, DD/A Offices in general have been subjected to sharper personnel reductions than were previously experienced. Over the long run, it will become more difficult for these Offices

to absorb increased costs while maintaining essential services. In the past, support activities have been cut back largely as programs they supported were cut back. Thus, reduced hiring lightened the load somewhat on the Offices of Personnel and Training; cutbacks in programs in Southeast Asia reduced the burden on the Office of Logistics. To some degree, a lessening in the quality of service was acceptable--maintenance of buildings and grounds could be deferred for awhile; some services could be performed with fewer personnel. Now, though, as the Agency is approaching core staff and activity levels, many support functions will grow in importance. Inevitably, recruitment must increase to replace personnel losses; training requirements will increase in response to increased hiring and greater emphasis on career development. Maintenance and repair of buildings and grounds will reach the level where they can no longer be ignored. There will be tradeoffs between reduced overseas staffing and increased costs of travel and communications.

Goods and Services

In the area of goods and services, we have given our attention to the heart of the problem--the effects of dramatic and unparalleled price escalations within the past two years and projections for the future of the inflationary trend.

Inflation has, to varying degrees, permeated all aspects of DD/A support since FY 1973. Naturally, the indicators are immediately visible in procurement and contracting activities. Beginning with the most basic category of procurement, that of consumable supplies, we have seen double- and even triple-digit inflation in many products. For example, the price of kraft file folders has jumped by a staggering 638 percent, and a box of 1,000 paper clips has leaped 700 percent. The most commonly used kinds of computer paper used by the Office of Joint Computer Support have increased in cost by an average of 71 percent, while two commonly used types of tabulating cards have risen an average of 84 percent. Inflation rates have varied widely for different types of items. For instance, the cost of telephone cable has increased 92 percent, while prices for most other items of expendable communications supplies have risen an average of 30 percent. Petroleum products, of course, have skyrocketed in cost. The price of gasoline has risen 83 percent, diesel fuel increased nearly 170 percent in cost, and antifreeze has bounded upward by 300 percent. During the period FY 1973-74, the cost of fuel oil
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for [redacted] increased by approximately 56 percent and has remained at that inflated level, despite all efforts to conserve energy.

Price increases in such basic products, while budgeted by DD/A Offices, affect the Agency across the board in that availability is sometimes decreased and conservation

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must be encouraged. Active programs were followed to seek economies at all levels in an attempt to at least partially offset such unprecedented price jumps and eliminate waste. The Office of Logistics and the Information Systems Analysis Staff fostered a paper-saving program and exhibit; the Office of Logistics reduced the selection of items available ~~for choosing~~ from the building supply rooms. At the [redacted] fuel oil consumption was reduced by 26 percent from 1972 usage; at the same time, electricity usage was reduced by 16 percent. The Computer Output Microfilm (COM) program is an innovation which is now and will continue to bring about savings on a large scale and on many fronts. For example, COM reduced the use of computer paper by an estimated 30 million sheets in FY 1974. Eventually, the savings in space and filing equipment brought about by further conversion to COM will be impressive. COM also saves computer time, printer use, and costs involved in handling, collating, and bursting vast quantities of paper.

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At some point, a core level of usage is reached in consumable supplies, and consumption becomes rather inelastic; the Agency may now be approaching that point with some products. Agency activities must continue, and very basic items are needed to support them. In most instances to date, Office requests for funding relief for price increases in consumable items have been met favorably and promptly during the budget year./ Economic indications now suggest that most of the skyrocketing in prices for consumable supplies is over and that prices will tend to level out, although at a high plane.

Capital-equipment purchases are, of course, more postponable than the supplies needed for day-to-day office and building operations. The effects of deferments differ according to function or program. Agency vehicle fleet replacement has been hampered somewhat by inflation factors of 39 and 35 percent respectively for sedans and station wagons over the past two years. It is becoming necessary for the [redacted]

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[redacted] to postpone some of its planned equipment purchases to later years. The Information Systems Analysis Staff is actively attempting to effect savings by reducing the number of copying machines in Agency buildings. The inventory of copiers/duplicators in the Headquarters area has decreased [redacted] since the beginning of FY 1974.

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It has been exceedingly difficult to satisfy increasing customer demand for expanded communications services (secure voice, data, facsimile, and imagery handling). In some instances, valid customer requirements have had to be deferred because of the effect of inflation on established communications budgets. Costs of most communications materials and equipment have increased an average of 37 percent in the past two years.

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even greater than they are now. The badge-machine program is in serious jeopardy because its implementation will now cost at least double the original estimates; as a result, the entire program is being reevaluated.

Further modernization of finance procedures through the increased use of computer technology is being delayed primarily because of drastically increased costs for computer equipment. However, the effects of inflation in computer technology are more subtle and complex than in other parts of the economy. While costs of computer equipment have, indeed, been rising, the computer itself has also been consistently improved in capacity and function, and the costs per unit of output have decreased. At the same time, though, computer workloads have increased because of the information-explosion

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phenomenon. For all of these reasons, the impact of inflation in computer usage cannot be isolated realistically. During this past fiscal year, IBM has instituted an eight percent increase in computer-rental equipment, but long-range, equipment-rental contracts are expected to offset cost increases in this area.

The Agency, like the economy in general, is consuming more services, and service prices, too, are rising. For instance, in the past ten years there has been a 62 percent increase in the cost of telephone service in the Agency, most of which can be attributed to inflation. Additional telephone-service rate increases can be expected in the not-too-distant future. US mail service is also experiencing fairly regular price increases. The FY 1974 postage-rate increase had an overall effect on the Agency of approximately a 15 percent rise. Increases of 30 percent in FY 1976 and an additional 20 percent in FY 1977 are anticipated. 25X1A

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needs. While external training costs are not necessarily borne by the Office of Training,
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Agency-wide budget estimates for external training [redacted]
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[redacted] highlight the problem. Although we are certain that a sizeable portion of the budgetary increases is occurring as a result of inflation, that factor is difficult to pinpoint because the budget estimates also reflect a greater reliance on training. The Office of Training's best estimate is that external training (including travel) costs approximately $5,000 per student today compared to $3,000 per student two years ago.

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## The Outlook

The pace of inflation seems to be subsiding for some products and services, but policies designed to end the recession may sustain future inflation. The annualization of the October 1974 Pay Act will produce a modest increase in the index for personal services. For the coming fiscal year, there is growing agreement that the pace of inflation will be between seven and 12 percent for goods and services. While this range sounds modest in terms of the recent pace of inflation, even a seven percent increase in costs would amount to [redacted] for the Directorate. Such an inflation factor can only be partially offset through increased efficiency and productivity measures.

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Current Guidelines and Practices

As long as can be remembered, Agency Program and Budget Calls have either expressed the concept of "no inflation" outright or have simply referred to Office of Management and Budget Circular A-11 as the guideline for preparing estimates. That Circular prescribes that price levels ". . . will be the same during the budget year as at the time the estimates are prepared. . . ." The only exceptions to this rule applicable to the Agency prescribe that, unless specifically justified, increases for average personnel compensation for the budget year for all causes cannot be more than one percent and that increases for wage-board personnel may be extended at a higher rate during the budget year if they were authorized during a previous year.

Informal guidance from Agency officials on budget preparation has varied over the years and, at some times, may have given some encouragement to provide for anticipated inflation; however, the extent of any such guidance, if existent, can be only speculated. Wherever practical now, Directorate Offices are battling inflation in two general ways:

> In situations where specific future prices are unknown, the logical, estimative process either consciously or subconsciously takes cost increases into consideration. While such expected cost increases may result from many factors, it must be admitted that inflation is one of them. Although this technique is imprecise and implicit, it does serve as some hedge against higher prices.
>
> Close observation to the dynamics of commercial price fluctuations for goods and services assist in the preparation of budget estimates and operating budgets. When suppliers pass on price increases to commercial consumers, it is virtually assured that similar price increases will be passed on to the Government. In a very few instances, Offices are able to budget for significant increases when future prices are quoted by manufacturers.

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These practicies, while implicit in nature, have served to protect the Agency's interests to some extent in the recent past.

Although most Government agencies generally abide by the Office of Management and Budget Circular A-11 guideline, one notable exception is the Department of Defense. For the past several years, an exemption to the pricing guidelines has been granted to that Department, allowing inclusion of an allowance for price escalation in RDT&E, procurement and construction estimates for major weapons systems, and military construction projects. This exemption has recently been extended to allow the Department of Defense to include a price-escalation factor in procurement appropriations for all purchases. The Office of Management and Budget, which endorsed this exemption to the "no-inflation" rule, would, of course, have to approve any further exceptions to the rule.

The rate of inflation allowed in Department of Defense budgets is a subject of current debate. The previously approved three to five percent rate is recognized as significantly inadequate. Department of Defense officials believe that realism in cost estimating in the military budget is essential in accurately portraying the defense posture in the President's Budget to Congress. Underestimating the rate of inflation, while better than ignoring it, causes proportionate and measurable distortion of what dollars will really buy when the budget year and the out-year programs are actually executed.

<u>Alternatives in Dealing with the Impact of Inflation</u>

For that important portion of the budget that comprises personal services, there is a fair measure of ad hoc protection against inflation through the periodic add-on, bottom-line entries which cover the costs of new pay increases. To the extent that the Agency is forced to absorb some of these increases, there may be, and usually is, pressure to reduce employment in support activities and in some lower priority operating activities.

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This is feasible if it is linked to expected increases in productivity or to the pruning of functions and services no longer needed. Across-the-board cuts not related to productivity gains are counterproductive, and deep cuts can be disruptive to personnel systems over the short run, through impact on morale, and in the long run, through distortions in structure (age, grade, and occupational profiles).

The impact of inflation may be particularly severe for those Offices which make substantial expenditures for goods and services, i.e., the Offices of Communications and Logistics. For each of these Offices, key policy decisions materially affect requirements and, hence, budget levels. However, once these decisions have been made by the appropriate authorities, the Offices face severe problems in protecting the purchasing power of their budgets while simultaneously meeting approved objectives. Requirements must be reviewed periodically to insure that resources are adequate to accomplish stated objectives.

Continuing inflation is likely to force reappraisal of some key management decisions at the Agency level. For example, higher costs for utilities, vehicle usage, and consumption of personnel time in commuting during working hours may make space consolidation of greater priority. Higher overseas costs may force reexamination of the Agency's dispersed field deployment. Such reexamination of key decisions would have major impacts on support costs. But once a requirement has been revalidated, management has a continuing problem in assuring that the desired level of support is maintained in the face of rising costs that eat away purchasing power.

The options in combating inflation appear to be few, consisting of the following, used either singly or in combination:

As a matter of Agency policy, provide each Office a lump-sum entry for inflation under such controls that budgetary discipline is maintained.

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Budget for inflation, under appropriate guidelines, where inflation is an appropriate consideration.

Use the Agency's contingency reserve for supplementary allotments to cover major unbudgeted cost increases.

Budget for inflation implicitly so that enough budgetary authority is provided to cover inflation but the justification is attributed to requirements.

If the Agency does not follow the across-the-board approach to budgeting for inflation, which is the approach followed in the Department of Defense and the former Atomic Energy Commission, it is possible to develop an approach for the Directorate which would be relatively selective, encouraging productivity gains and conservation while protecting the activities most vulnerable to the erosion of inflation. The following recommendations would establish such an approach:

Recommendations

Since individual Offices are most knowledgeable of inflation rates and impact in their areas, each Office be given authority to budget for inflation with the proviso that the rationale for items covered, rates used, and amounts budgeted support the budget submission and be subject to review as any other item in the budget.

Office programs should address productivity increases with the objective of achieving specified economies of personnel and goods and services.

Offices which make substantial expenditures for equipment or for maintenance of installations should be required to develop capital budgeting. This technique would support more realistic assessment of the consequences of postponing needed expenditures and would help to assure that long-range considerations are interjected into the annual program review.

Intensive efforts to reduce operating costs by all levels of management should continue. Although most areas where large savings can be achieved already may have been

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identified, any new opportunity which arises should be seized upon. In conclusion, constant vigilance will be necessary on the part of Agency management to keep pace with changing trends and to chart the course for timely action measures.


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